On Taxes . . .

Ranchers, Taxes and a Drought Situation

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If you remember the expression "Don't sell the farm," you know it means don't give up everything you own. Unfortunately for many ranchers in Texas and other drought areas, that expression has taken on a truer-than-life meaning and cannot be ignored.

Drought conditions have forced economic decisions on ranchers to either reduce or even liquidate herds or invest significant monies into the purchase of outside feed. Many ranchers have chosen to sell.

With tax time now approaching, such ranchers have still another headache to face. Because of an earlier decision to sell or even completely liquidate their herds, cash-basis taxpayers will most likely have more gross sales, more taxable income and more income tax liability than in any given "normal year." Luckily there are two provisions built into the Federal Tax Code which give distressed ranchers some sorely needed tax breaks.

. . . a rancher who sells certain livestock due to a drought can defer the excess income he receives over his normal sales until the tax year following the year of sale.

These provisions give ranchers the opportunity to defer, or postpone, the reporting of income from selling off livestock until a year or two after the year of sale.

Tax deferral

Section 451 of the Internal Revenue Code (IRC) states in essence that a rancher who sells certain livestock due to a drought can defer the excess income he receives over his normal sales until the tax year following the year of sale.

Tax deferral does not apply to any livestock held for draft, breeding, dairy or sporting purposes, which are held by the taxpayer for two years or more (cattle and horses) or one year or more (other livestock). In essence, this deferral provision applies primarily to non-breeding herd such as steers, yearlings and calves.

Also, the taxpayer must be in the "principal" business of farming (ranching) to qualify for the deferral. Tax deferral also is only available to ranchers who use the cash receipts and disbursements, or cash, method of accounting. (Under this system, ranchers inventory their livestock at the actual purchase price paid for the animals, and livestock raised on the ranch are not valued. In addition, many costs of raising these animals are deducted as a current expense.)

To receive the tax deferral, ranchers must file an election by the due date of their tax return. This election must include a detailed statement which provides, in short, a declaration; evidence of the drought conditions; an explanation of the relationship between the drought area and the taxpayer's early sale or exchange of livestock; a history of normal business and drought-year sales; and the amount of income to be deferred.

The essence of this provision is to allow the rancher to defer his "excess income over normal" until the following year. However, ranchers who make elections for successive years must use actual income to compute what is "normal" and disregard any previous deferral elections.

Involuntary conversion

Another significant tax break available to ranchers comes under the ill-sounding category of "involuntary conversion." Unlike the one-year tax deferral on income from non-breeding livestock sales, the involuntary conversion rule applies to livestock (other than poultry) held for draft, breeding or dairy purposes.

IRC Section 1033 gives ranchers the option of deferring taxes on net income from excess breeding herd sales due to drought for up to two years. The only stipulation is that the rancher must replace the livestock with livestock of a "like-kind" (for example, breeding cattle with breeding cattle) within two years from the close of the year in which the original gain was realized (replacement costs must equal or exceed gross income from deferred sales). In addition, the tax basis of the new animals purchased for purposes of depreciation and Investment Tax Credit is reduced for the previous portion of the unreported gain.

Unlike the rules under IRC Section 451, the involuntary conversion section does not require the taxpayer to be in the "principal" business of ranching. Also, the drought area does not have to be officially declared eligible for federal government assistance.

Should a rancher incur a net loss from the sale of breeding herd, he most likely should deduct that amount in the year in which it is sustained and not elect the deferral provision of IRC Section 1033.

Congress has given the rancher a vehicle to postpone tax created due to an act of nature, but has made compliance with rules technical and meticulous.

Since involuntary conversion rules are more difficult to administer when ranchers do not comply with the reinvestment requirements under involuntary conversion provisions (tax liability must be recomputed and an amended tax return filed), an involuntary conversion should only be elected when the required reinvestment is actually intended.

Drought conditions of the past year put a premium on advance planning. Ranchers can receive tax benefits from drought sales, but they must follow the election rules carefully. Congress has given the rancher a vehicle to postpone tax created due to an act of nature, but has made compliance with rules technical and meticulous. But utilization of these provisions for deferring income tax liabilities when ranchers are experiencing difficult years gives ranchers somewhat of a reprieve in an otherwise distressing situation. AJ

For more information on this or other tax-related issues, readers are encouraged to seek competent tax advice. The basic concepts presented here are of a general nature. The authors may be reached at Ernst & Whinney, San Antonio. Jones specializes in estate and gift taxation and taxation of farmers and ranchers. Howell, manager of the Laredo office tax department, specializes in taxation of south Texas cattlemen.

On Taxes...

Investment Tax Credit and Limited Expense Options

by Jack and Sharon Truitt, Moscow, Idaho

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Cattle breeders currently are faced with a variety of complex income tax rules. The Economic Recovery Tax Act of 1981 (ERTA) created the expensing option and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established the investment tax credit (ITC) option.

As a result of the ERTA of 1981, cattle breeders may now elect to expense breeding cattle or other business property that qualifies for ITC acquired by purchase for use in a business or trade. Although the maximum deduction was originally established as $5,000 for 1983, $7,500 for 1984 and 1985 and $10,000 thereafter, Congress recently froze the maximum deduction at $5,000 until 1988.

The election to expense recovery property (i.e., breeding cattle) must specify the property or portion of the property that is to be expensed. Once the election and specification of the property is made, the decision is irrevocable except with the consent of the Internal Revenue Service (IRS). Unfortunately, the IRS counterbalanced the tax advantage of immediately expensing the cost of breeding cattle (or other property) by eliminating the ITC applicable to expensed property. The TEFRA of 1982 further complicated this decision by requiring the taxpayer to select between two options concerning the amount of ITC taken. Specifically, if the taxpayer takes the full ITC, he must reduce the cost (depreciable basis) of the property by one-half of the ITC taken. Alternatively, the taxpayer can reduce the normal ITC rate by two percentage points and depreciate the full cost of the property.

Cattle breeders must decide whether it is better to forgo the ITC and cost recovery through ACRS depreciation allowance or to immediately expense the cost of the property ($5,000 limit). In order to make the proper decision the cattle breeder must equate the present value of immediately expensing the property with the present value of the ITC plus the present value of the ACRS depreciation deductions over the recovery period. Breeding cattle are considered five-year property and their cost is deductible over a five-year period at the following rates: year 1, 15 percent; year 2, 22 percent; and years 3 through 5, 21 percent.

If the cattle breeder decides to take the ITC on the cow, then the IRS allows another option: You may take a 10 percent ITC on five-year property, but you have to reduce the basis of the depreciable property by one-half of the ITC taken; or you can take an 8 percent ITC, in which case you do not have to reduce the basis of the depreciable property.

Suppose a breeder purchases breeding cows for $5,000 during 1984, which have a five-year recovery life. The cattle breeder has three options under the current tax system. These three options are:

1) Immediately expense the cost of the cow.
2) Take a 10 percent investment tax credit and reduce the cost of the cow by half of the ITC taken, and then depreciate the cow over its five-year life.
3) Take an 8 percent investment tax credit and depreciate the original cost of the cow over its five-year recovery period.

For most individuals and partnerships, it is better to take the higher ITC option and reduce the basis of your asset by half of the ITC taken, so the third option can be eliminated. For example, a taxpayer in the 50-percent tax bracket would have to have a cost of capital (desired rate of return or current borrowing rate) of less than 12 percent for it to be advantageous to select the lower ITC rate. The cost of capital (interest rate) and the marginal tax rate are inversely related; therefore, as the tax rate decreases or the interest rate increases the third option becomes less desirable.

The equation in Exhibit 1 helps weigh the other two options. If the net present value (NPV) of tax savings differential is positive, it is best to take the ITC and depreciate the cow. If the NPV of the equation is negative, it is best to immediately expense the property.

The net present value of capitalizing rather than expensing is presented in Exhibit 2 for various tax and interest rates. The results indicate that for five-year property immediate expensing is advantageous for relatively high interest rates and relatively high tax rates. At low tax rates such as 15 percent, however, it is always better to take ITC and depreciation.

In general, cattle breeders that have a marginal tax rate of 30 percent or less and a cost of capital of 20 percent or less should take the ITC and depreciate their property instead of expensing. If your cost of capital exceeds 25 percent and/or your marginal tax rate is greater than 30 percent, then you can simply plug the numbers that are appropriate to your particular situation into the equation in Exhibit 1 and generate the optimal answer. AJ

Exhibit 1. Calculating net present value of tax savings.

$$NPV = ((C)(ITC) + \sum_{j=1}^{N} \frac{(.95C)(CRR_N)(T)}{(1+i)^{j-1}} - Exp$$

NPV = Present value of tax savings differential
C = Cost of the depreciable asset
ITC = Investment tax credit rate
Exp = Present value of immediate expensing (C · T)
CRR = Cost recovery rates under ACRS
N = Life of the investment (recovery period)
T = Marginal tax rate
i = Cost of capital (interest rate)
j = Investment year (investment in year j = 1)

Exhibit 2. Net Present Value Advantage of Capitalizing (Expensing) for Five-Year Property for $5,000 of Asset Cost

Tax Rate %	Interest Rate (%) 10	15	20	25
50	($ 38.10)*	($199.18)	($332.83)	($446.90)
40	$ 67.04	($ 59.35)	($166.27)	($257.52)
30	$175.28	$ 80.50	$ .30	($ 68.14)
15	$337.66	$290.25	$220.17	$215.94

**This is the only situation in the exhibit where it was advantageous to consider the reduced ITC rate, even though expensing was still the best option.*